

How Regional Integration and Transnational Energy Networks Have Boosted FDI in Turkey (and May Cease to Do So)

A Case Study: How Geo-Political Alliances and Regional Networks Matter

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Abstract

Turkey has historically struggled to attract foreign investors. This paper argues that not only macroeconomic and political stability, but also regional integration explains the upsurge in foreign direct investment observed since 2005. The analysis draws from a qualitative framework. It discusses how, contrary to the Customs Union Treaty for industrial products with the European Union, the official start of the European Union's accession to negotiations in 2005 encompassed a wide set of reforms in several chapters

directly or indirectly affecting the business climate. The reforms helped to enhance foreign direct investment attraction in Turkey. However, it seems that the global economic slowdown starting in 2009 and increasing Euro-skepticism have already started to erode this effect. Only large foreign investment in the energy sector observed in 2009–13, explained by the energy security strategy of the European Union and the privatization agenda, has prevented the collapse of foreign direct investment inflows to Turkey.

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1. Motivation

Turkey constitutes a very interesting case to study capital flows and, more concretely, foreign direct investment (FDI). The country counts with an enviable geo-strategic location both for business and for international relations (Brzezinski, 1997). Additionally, it has traditionally enjoyed privileged relations with the United States and the European Union (EU)². Turkey embraced structural adjustment programs in the 1980s and capital account opening in the 1990s. However, in spite of these facts, if we compare Turkey's case to other emerging markets with similar levels of per capita GNI such as Mexico or Brazil, Turkey has been traditionally characterized by low levels of FDI (just around 0.5% of the GDP for most of the 1980s and 1990s). In fact, during the 1990s and early 2000s, the country suffered several sudden stops associated to short-term capital outflows. It will be necessary to understand the reasons behind this disappointing performance in attracting and keeping foreign capital.

Most of the authors consider that macroeconomic instability has been the main deterrent of foreign direct investment in Turkey (e.g. Uctum and Uctum, 2005; Basar and Tosunoglu, 2006). Faulty institutions and the slow pace of privatization have also been blamed (Erdilek, 2003; Dumludag et al., 2007). The question now is whether this explanation, which seems to fit well with the events of the 1990s, is sufficient to also account for the surge in FDI inflows experienced in the second half of the 2000s.

In principle, one may think that the increasing FDI inflows observed since 2005 is just the product of the enhanced economic and political stability brought by the successive governments of Erdogan's *Adalet ve Kalkınma Partisi* (AKP, assuming office in November 2002). However, in line with Sayek (2007), we will argue in this paper that the EU accession negotiations (launched in 2005) have also played an important role in helping Turkey boost FDI inflows.

Thus, it is the aim of this paper to understand how evolving relationships with the EU and the accession process have enhanced FDI attraction in Turkey (and may cease to do so). We try to contribute to existing research in the following ways: (i) by complementing with a country -specific case study with existing cross-country analysis of FDI determinants; (ii) by bringing regional integration considerations to the literature discussing FDI in Turkey; and (iii) by presenting a geo-strategic perspective that will help explain the relevance foreign investment in energy has acquired in the past five years.

² Turkey has been an associate state to the European Economic Community since 1963, which implied progressive reduction in import tariffs (Ankara Agreement); in 1999 the Helsinki European Council recognised Turkey as a candidate for EU membership; in 2005 accession negotiations to the EU started officially.

Drawing from the qualitative framework elaborated by Blomstrom and Kokko (1997), our analysis suggests that the EU-Turkey Customs Union Agreement of 1996 served well the purpose of enhancing bilateral trade flows. However, it did not help significantly to the expansion of FDI inflows because it did not entail free capital mobility (as the one enjoyed by the members of the Common Market). Moreover, it did not generate significant changes in the business climate, and the implementation of the Customs Union considered a 5-year grace period for the alignment of certain trade policy aspects. On the other hand, the official start of the EU accession negotiations in 2005 involved a wide set of accompanying reforms in 35 chapters of the *acquis communautaire*, including free movement of goods, right of establishment to provide services, competition policy, financial services, energy, regional policy or the customs union. The signaling of expected progress in the business environment associated to the accession process has helped enhancing the attractiveness of Turkey at the eyes of the foreign investor. We also find how even when remaining significantly above the levels observed in the 1990s and early 2000s, FDI inflows to GDP have somewhat contracted since 2009 in the context of the global financial crisis, resulting in a change in the EU's priorities and weaker accession prospects for Turkey. Only in the energy and electricity sectors FDI inflows have significantly expanded, in part due to European interests in creating transnational energy corridors involving Turkey.

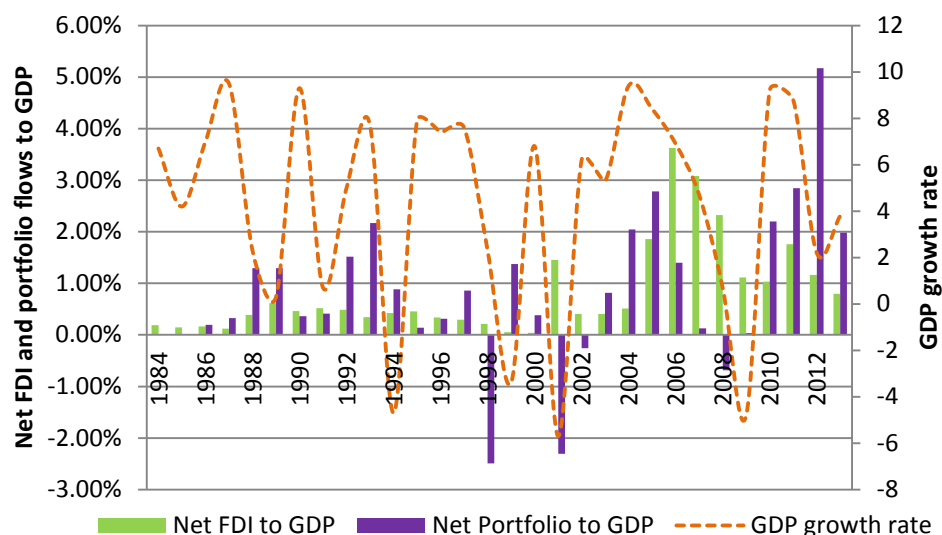
In sum, we would like to gain a better understanding about regional integration processes that have influenced FDI attraction in Turkey. The rest of this paper is divided as follows. Section 2 presents a brief look at economic and political developments occurred over the last three decades in Turkey. Section 3 summarizes the main research findings contained in existing literature discussing FDI in Turkey. Section 4 presents the qualitative discussion on the effects of different EU integration stages on foreign investment. Section 5 looks at the concrete case of booming FDI in the energy sector, which needs to be explained by looking at trans-regional logistics and geo-political factors. Finally, section 6 offers a conclusion for the previous sections.

2. Three decades of liberalization in Turkey

In the aftermath of the 1979's foreign exchange crisis, Turkey signed a “Structural Adjustment Loan” with the World Bank in March and a three-year deal with the IMF in June. The recovery plan implied a transformation of an exhausted import-substituting model into an export-oriented open economy (see Önis, 1998). During the 1980s, Turkey experienced a relatively successful growth and export performance, but at the expense of real wages and increasing income inequalities (Botarav and Yeldan, 2001).

Economic liberalization and the previously mentioned market-orientated measures, promoted by Turgut Özal’s government, did not result in significant foreign investment attraction. Önis (1994) argues that the orthodox approach of shifting incentives to foster FDI is insufficient if investors do not rely on the sustainability of the new regime. A large foreign debt stock, lack of confidence between foreign companies and the government, and the persistence of subsidies and protectionist measures in certain sectors were probably some of the reasons why inward FDI continued to be low during the 1980s.

Figure 1. Capital flows and sudden stops in the Turkish economy



Source: Central Bank of Turkey and IMF Article IV estimates (December 2013)

In 1989 Turkey took a step ahead in its liberalization process by fully opening its capital account to foreign flows (Önder, 2007). This measure has been a subject of controversy, as macroeconomic instability increased and the country was exposed to several sudden stops in the following decade (1994, 1998 and 2000-2001). Moreover, the country was not able to significantly increase FDI attraction, as most of the inward capital flows were driven by short-term speculative purposes.

Demir (2004) summarizes the different explanations given to the unsatisfactory performance of Turkey during the 1990s. On the one hand, existing bureaucracy and domestic institutional inefficiencies could have had a negative impact on the outcome of the reforms (see, for instance, Celasun et al., 1999). On the other hand, while recognizing disturbances introduced by the government, most of the Turkish economists (Önis, 1998; Botarav and Yeldan, 2001) attribute the problems to deficiencies in the

adopted liberalization approach, such as insufficient consideration of the distinguishing features of the Turkish economy. A third view is that of a timing-failure in the execution of the different reforms.

The mentioned decade of political and economic instability ended up with Turkey suffering from twin crises in November 2000 (mainly of financial nature) and in February 2001 (currency and balance of payments crisis). Interestingly, the economic slump would be the turning point leading into a new era. The fact that the collapse was severe and widespread across sectors and economic actors, the figure of Kemal Dervis as a coordinator of the government's dialogue with the International Monetary Fund (IMF) and the World Bank (WB), as well as EU membership prospects are some of the factors identified by Arpac et al (2008) as helpful to overcome the pressures of interest groups and start the implementation of an ambitious set of reforms in the aftermath of the crisis.

In November 2002, Erdogan's AK party succeeded at General Elections. Despite fears that the new inexperienced government could re-initiate the adoption of populist measures and fiscal indiscipline, they fully committed to continue the ambitious reform program set up by the previous coalition (led by Kemal Dervis).

In this setting, new FDI regulation came into force in 2003 removing the requirement of a permission to create new companies with foreign capital and easing the investment process. In addition to that, reforms included a new capital markets law, enhanced corporate governance measures and accelerated privatization. In October 2005 negotiations with the EU regarding Turkey's accession officially started. This process helped to accelerate economic and institutional reforms, which reinforced stability and business expectations until the outbreak of the world financial crisis in 2008 (see Uckun and Doerr, 2010).

In 2008, as the economy started to head into recession, which was perceived in advance by the markets, the country suffered a net portfolio outflow. However, unlike the crises of 1998-99 and 2001, portfolio flight was moderate (0.7% of GDP, compared to more than 2% of GDP in the previous crises), and this time it was compensated by large FDI inflows. Economic growth bounced back well in 2010 and 2011, and large portfolio inflows have returned to Turkey. However, vanishing EU accession prospects combined with more shaky growth prospects and exchange rate instability seem to have undermined FDI attraction potential; yearly inflows are less than half of those observed prior to the global economic slowdown. In addition, developments affecting rule of law and protests by part of the citizenry may hamper FDI inflows to Turkey in the future.

3. A literature review on the determinants of FDI in Turkey

Existing literature dealing with foreign direct investment in Turkey is heterogeneous, presents different focuses and draws from dissimilar theoretical approaches and methodological tools (see Table 1 in the Annex). In order to synthesize existing empirical evidence, we group the studies depending on the determinants of FDI they discuss and the methodology applied.

A first set of articles departs from OLI's eclectic paradigm (see Dunning, 2001) which tries to determine the location, ownership and internalization factors that influence the establishment of multinational enterprises in Turkey. Collection of survey data at the firm level is usually the method adopted by these studies.

Tatoglu and Glaister (1998) conducted a survey on motivations for foreign direct investment in Turkey on a purposive sample of 316 foreign equity ventures. There is evidence that among the most relevant factors influencing location in Turkey are its market size (and the related growth rate) and certain government policies such as the possibility to repatriate profits.

In a similar fashion, Tatoglu and Glaister (2000) examine the location, transaction and firm related factors in the establishment of foreign companies in Turkey. For this purpose, they adopt a managerial approach, drawing mainly from industrial organization models, internalization theory and the eclectic paradigm. Erdilek (2001) has criticized this research for being *<<narrowly focused>>* and providing *<<no in-depth analysis of the economic, political and social factors that determine Turkey's attractiveness as a host country to foreign investors>>*. Tatoglu et al (2003) analyze the determinants for foreign ownership in Turkish manufacturing (fully owned enterprise, joint venture, etc.). Their findings suggest that there are country-related factors that influence the formula of foreign investment access to the host economy. The authors recommend Turkish policy makers to continue pursuing structural transformation and privatization, but these suggestions do not seem to be clearly derived from the empirical results.

Deichmann et al (2003) use a conditional logit model in order to identify the location patterns of multinational enterprises in Turkey. The location decision will depend more on the characteristics of the industry (productivity, agglomeration of similar firms) and on local conditions (coastal access, infrastructures, etc.). Public investment's share on regional GDP does not seem to be an influencing factor. Another group of scholars has looked at the geographical distribution of FDI within Turkey,

highlighting increasing regional divergences (Berköz, 2001; Erkut and Baypinar, 2003; Berköz and Turk, 2009).

Lenger and Taymaz (2007) study innovation and technology transfer activities in Turkey and observe that foreign owned firms are on average more innovative than domestic ones. They also find that the main channel of spillovers is workers' acquired knowledge. There does not seem to be much evidence of significant horizontal or vertical spillovers at the industry level. Therefore, not all of the alleged benefits of FDI may be easily and unconditionally achieved in reality.

Whether these studies usually contain useful guidance from a managerial perspective (joint venture choice, location...), they do not always provide hints for the policy maker. As it is acknowledged by some of the authors, this approach needs to be complemented with a macroeconomic perspective to fully understand the determinants of FDI in Turkey (Tatoglu et al, 2003).

A second strand of literature has a wider focus which normally considers macroeconomics and policy determinants of FDI. Their aim is varied, but they have in common the use of a quantitative analytical approach, often in the form of cross country regression.

Erdilek (2003) analyzes the causes for the low levels of both inward and outward FDI in Turkey. He blames internal factors such as

<<chronic high inflation, increasing economic instability, inward orientation until 1980, lack of protection of intellectual property rights, lack of inflation accounting and internationally acceptable accounting standards, failure of privatization, insufficient legal structure and inadequate infrastructure>>.

Erdilek (2003)

Similarly, Basar and Tosunoglu (2006) conclude that Turkey seems to be attracting less FDI than expected (given the size of its economy), and this is probably a result of high inflation rates and macroeconomic instability.

During the 1980s and 1990s it was believed that capital account liberalization would result in increased foreign investment attraction (see, for instance, Desai et al., 2006). However, this resulted to be a necessary but not sufficient condition to enhance FDI inflows. Apart from counting with reliable macroeconomic management, a stable investment framework and efficient institutions seem to be necessary to appeal the foreign investor. Dumludag et al (2007) perform cross-country regression to find that lack of corruption, transparency, rule of law or security of property rights contribute positively to FDI attraction. In the second part of the paper the authors present the results of a survey which seem to

confirm that, in Turkey, macroeconomic instability, inflation and deficient institutions are perceived as barriers to FDI attraction³.

Uctum and Uctum (2005) look at Foreign Portfolio Inflows (FPI) and Foreign Direct Investment flows in Turkey with a different methodology: by plugging data into a model in order to understand how punctual crises have affected capital flows in Turkey. They conclude that *<<institutional factors, structural reforms and crises affect both components asymmetrically. FPI is vulnerable to regional contagion (Russian crisis) and responds negatively to financial risk, while FDI is sensitive to economic risk but is not affected by contagion>>*. This result seems to confirm that FDI inflows were deterred during the 1990s due to economic risk, whereas during 2002-2008 foreign investors were attracted by the more stable economic situation.

A recent study by Bilgili et al (2012) employs Markov Regime-Switching Models to study the determinants of FDI in Turkey from a non-linear approach. They conclude that FDI inflows are positively correlated with economic growth in Turkey, decreasing country risk and expansion in exports, whereas labor costs, imports and currency depreciation expectations have a negative impact on FDI in Turkey. Results point to non-linearities and significant structural breaks in 1988, 1996, 2001, and 2005-2006. While 1988 and 2001 are clearly identified as years in which there was a mayor crisis in Turkey, this is not the case in 1996, and 2005-2006. The authors attribute these breaks to temporary increases in the risk perception indicator for Turkey due to political developments such as uncertainty under elections and the announcement of the opening of a nuclear reactor. In the next section we will argue that, while we agree that temporal sudden stops in FDI inflows observed in certain quarters in those years may be attributed to the perception of political risk, another factor behind the change in trends observed after 1996 and, especially, after 2005 may have been regional integration prospects.

A third group of studies argues that, in addition to macroeconomic and institutional factors, regional integration and, more concretely, accession prospects to the European Union have significantly helped Turkey attracting FDI. This approach is intimately related to the institutional views, as it can be understood that certain forms of regional integration agreement often incorporate intellectual and investment protection clauses, and often encompass an improvement in doing business.

In line with the studies previously mentioned, Loewendahl and Ertugal-Loewendahl (2000) concluded that *<<Turkey has under-performed in attracting FDI due to the slow pace of privatization and*

³However their derived conclusion that an improved institutional framework should be the priority is at best tentative and should be tested, since most of the factors considered in the questionnaire have a similar average mark (between 3.5 and 4). It is therefore very difficult to discriminate the most relevant causes from the rest.

political-institutional obstacles, of which chronic inflation is a manifestation>>. In addition, the authors introduce the regional dimension by providing an interesting explanation to the low impact of 1996 Customs Union Treaty with the EU on FDI. They observe that, even when announced FDI increased significantly in the aftermath of the agreement, effective investment remained low. This suggests that the government did not address efficiently the interest shown by foreign investors. Even when Turkey was supposed to improve competition law and to introduce industrial and technical standards, the necessary reforms were not always efficiently implemented (Francois, 2005:124)

Another important milestone from the regional integration perspective is the beginning of accession negotiations to the EU in 2005. Zaman (2005) already predicted an increase in inward FDI to Turkey in the aftermath of the agreement, something that seems to have been confirmed. Similarly, Dutz et al. (2005) also argued that the opening of the EU accession negotiations would be beneficial for inward FDI, given that Turkey committed to progress in the adoption of the common *acquis*. According to Uckun and Doerr (2010), the combination of improvements in the domestic investment framework (FDI law, capital market reforms, banking sector reforms, etc.), together with the availability of global financial funds during 2003-2008 facilitated the unprecedented increase of FDI inflows.

Sayek (2007) argues that the recent upsurge in FDI in Turkey has been mainly caused by the beginning of accession negotiations to the EU, whereas the success in inflation reduction has not had a relevant impact. Additionally, institutional variables are found to contribute positively to inward FDI flows, a finding that is in line with the results obtained by Dumludag et al (2007).

More recent studies also highlight the relevance of regional integration for FDI in Turkey. Esiyok (2011) uses a gravity model based on the capital-knowledge theory and confirms most of the results obtained by previous authors on macroeconomic and institutional determinants of FDI. In addition, he finds that foreign investors in Turkey are mainly motivated by market access purposes (horizontal FDI), as the costs of exporting to Turkey are relatively high (compared to other OECD countries). The results on market orientation are similar to those discussed by Çetin and Taban (2009) and Onaran (2009). In addition, according to Esiyok (2011), FDI flows to Turkey respond positively to the EU accession process, as well as to bilateral trade treaties with third countries. Similarly, Gungor and Binatli (2010), when analyzing a panel data consisting of eleven countries involved in EU accession at different stages, including Turkey, conclude that progress in this process results in a significant increase of FDI inflows. According to Bosco (2011), Turkey still presents an unexploited potential in terms of additional FDI stock, ranging 200% to 1000%; further progress in EU accession could help to take advantage of this potential.

To sum up, it is possible to conclude that the literature discussing foreign direct investment in Turkey points to economic and political unsteadiness during the 1990s as the main deterrent for permanent inward capital flows to the economy. Over the past decade, reduced inflation levels coupled with improvements in institutions helped Turkey attracting foreign investors. At the same time, and related also to institutional aspects, a number of authors argue that the signaling of the EU accession negotiations contributed also significantly to the boost in FDI inflows observed from 2005 onwards. It is the aim of this paper to discuss the role of recent regional integration processes on FDI attraction in Turkey.

4. Regional integration and FDI in Turkey: A qualitative framework analysis

It has been argued in recent studies that regional integration and, more concretely, the official start of accession negotiations with the European Union, is one of the main factors explaining the significant increase in FDI flows to Turkey observed in the second half of the past decade. In this section, we discuss the role of regional integration in foreign investment drawing from the qualitative analysis framework elaborated by Blomstrom and Kokko (1997). We wonder why FDI did not start to flow earlier, considering that Turkey signed a Customs Union agreement for industrial products with the European Economic Community in 1996, which was a notable step ahead in regional integration.

Regional integration: Customs Union agreement with the EU and inward FDI in Turkey

In 1996 Turkey entered in a Customs Union agreement with the European Economic Community, adopting a common external tariff for most manufactured products, and eliminating all customs duties, quotas and charges affecting bilateral exchange. This has helped Turkey significantly to boost trade with the EU. According to World Bank (2014:23,24) simulations, the value of Turkish exports from the EU and EU exports to Turkey would have been 3.0-7.2 percent and 4.2 percent smaller, respectively, if they had signed a free trade agreement instead of a custom union. Another positive contribution of the Customs Union is that it has facilitated the integration of Turkey into regional value chains. The World Bank (2014) concludes that, even if the Customs Union has been successful in fostering trade, a series of limitations (persisting restrictions in trading agricultural products, road transport permits, EU visa restrictions) and asymmetries (in Turkish participation in the decision making,

negotiations with third countries, etc.) would need to be addressed to adapt the agreement to current times (and EU enlargement) and maximize its potential.

In what regards to foreign direct investment, in principle, an increase of extra-regional flows to Turkey in the aftermath of this 1996 Customs Union agreement on industrial products would be expected, since foreign multinationals could use the country as an export platform to serve the EU. Additionally, a raise in vertical FDI from Europe to Turkey would offset the theoretical decrease in the number of previously installed market seeking multinationals (which do no longer face tariffs and can serve the Turkish market from the country of origin).

By looking at FDI inflows by country of origin, it is possible to observe that European investors were already dominating foreign investment in Turkey prior to 1996. If we compare the 1980s and the 1990s, except for the Netherlands (+13%), the United Kingdom (-7%) and Switzerland (-7%), there are not significant variations in most of the countries' share of contribution to FDI in Turkey. The Customs Union agreement apparently did not alter the share hold by European Union investors (EU15), which stayed around 65% both before (1994) and after (1998) the agreement, even in 1996 when there was an upsurge in Turkish inward FDI dominated by EU investors (85%). In addition, in relative terms total FDI flows to GDP did not increase compared to the previous year. In fact, aggregate FDI inflows remained stuck around 0.5% of the Turkish GDP. This is unexpected according to the theory. In this case, a greater degree of regional integration did not lead to a significant boost on FDI from European or extra-regional investors. Nonetheless, it is worth noticing that European FDI to Turkey was already much more substantial than flows from, for example, the United States (averaging less than 8% of total flows to Turkey in 2000-2010), who do not hold trade agreements with Turkey. Turkish literature considered in the previous section pointed mainly to macroeconomic and political instability as the major deterrents for additional foreign investment in the 1990s. It is also worth noting that Utkulu and Seymen (2004) did not observe significant shifts in comparative advantages when Turkey joined the Customs Union with the European Community.

Apart from macroeconomic and political factors, we argue that the nature of regional integration processes influence the amount of FDI inflows. The EC-Turkey Association Council of 1995⁴ decided on the implementation of a Customs Union (except for agricultural products, coal and steel), which was considered as the final stage envisaged in the Ankara Association Agreement of 1963. The decision encompassed free movement of goods (there are not specific provisions for services) and the

⁴ Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union. Official Journal L 035 , 13/02/1996 P. 0001 – 0047.

alignment of Turkey with the European Community common customs tariff, including preferential arrangements with third parties and harmonization of commercial policy measures; it also suggested approximation to EU intellectual property, competition and taxation laws.

The removal of technical barriers and the alignment of commercial policy with that of the EU were envisaged to be progressively applied over a five year period. This could partly explain that there was not an immediate surge of FDI following the signature of the Customs Union. In addition, some of the accompanying reforms (e.g. competition, removal of subsidies) were not fully implemented. It is also worth noting that a Customs Union agreement does not imply full capital mobility, like that enjoyed by the members of a Common Market (Jovanovic, 1997). Therefore, introduced changes were not sufficient to strongly appeal investors, as Harrison et al (1997) had predicted.

Related to this, other authors argue that excessive red tape and interferences at the local level were acting as deterrents of FDI. This view seems to be shared by Dutz et al (2005), who blame a static bureaucracy, rent seeking activities and the lack of a stable investment framework.

In sum, we argue that the Customs Union agreement between Turkey and the European Union of 1996 was successful in fostering foreign trade in manufacturing (its main purpose), but did not result in a significant boost in FDI attraction because it did not entail wide reforms on the business and investment framework beyond trade preferences. At the same time, we acknowledge that economic and political instability during the 1990s and early 2000s, as well as administrative hurdles may also partly explain why Turkey did not experience a significant increase in FDI inflows in the second half of the 1990s, and it is not easy to clearly point out to the most influential factor.

Regional integration: the impact of EU accession negotiations on FDI

In the period beginning in 2003, and especially from 2005 onwards, there has been an outbreak of FDI flowing to Turkey. Why has this phenomenon happened relatively late, and not before, when the EU and Turkey signed the Customs Union Agreement? Our tentative hypothesis is that, in the last decade, apart from improved economic and political stability, deeper reforms aimed at preparing Turkey towards EU membership have facilitated an improvement of the investment climate and expectations of a fast expansion in economic activity.

Talks for the accession of Turkey to the European Union officially started in 2005. The negotiating framework⁵ contains provisions regarding 35 chapters of the *acquis communautaire*. Thus,

⁵ Accessible at http://ec.europa.eu/enlargement/candidate-countries/turkey/key_documents_en.htm.

Turkey has been working to implement new commitments in areas such as free movement of goods, right of establishment to provide services, competition policy, financial services, energy, regional policy or the Customs Union (Council of Europe, 2008). Therefore, accession negotiations involve much more comprehensive reforms than the Customs Union Treaty (that basically dealt with just two of these chapters), which improves business climate and enhances investment framework.

Sayek (2007) presents some cross-country evidence suggesting that <<...it is in fact the signaling of the membership and the road to membership, rather than the final membership itself, that has the great effect [on FDI]>>. By taking a look at the evolution of foreign investment flows to Turkey over the past decade, it is possible to observe that the surge in capital started in 2005, when Turkey and the EU officially initiated accession conversations, and the momentum lasted at least until 2008. In the context of the global economic slowdown, accession prospects for Turkey somewhat cooled down, as the European Union had to focus in finding a way out of the crisis, and enlargement conversations lost relevance in the agenda of priorities. At the same time, the latest reports by the European Union point to a slow and unequal implementation of reforms aimed at aligning Turkey with the *Acquis Communautaire*. So far, accession negotiations have been opened on 13 chapters⁶ out of a total of 33, and only one of them (Science and research) has been provisionally closed (EU Commission, 2013). Even if EU authorities report an advanced stage of alignment in free movement of goods or intellectual property rights, other chapters such as free movement of capital present a more modest progress, and there are many areas in which reforms are still incipient. In addition, prevalent restrictions on the relationships between Turkey and Cyprus prevent, since the end of 2006, the opening for negotiations of eight chapters⁷, including the right of establishment. Thus, slow developments and weaker membership prospects could partly help explaining why Turkey is not seeing nowadays the same level of FDI inflows observed in 2005-2008.

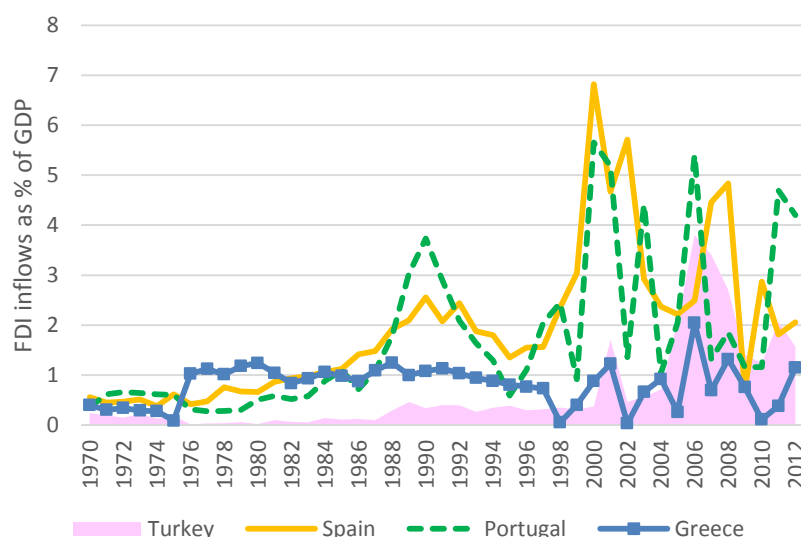
Blomstron and Kokko (1997) elaborated a qualitative theoretical framework to assess overall impact of regionalization on FDI attraction according to the location of the host country and the degree of environmental change derived from the agreement. From this perspective we could be able to explain the differences in performance of different members of the same regional integration agreement.

⁶ Science and research; Enterprise and industry; Statistics; Financial control; Trans-European networks; Consumer and health protection; Intellectual property law; Company law; Information society and media; Free movement of capital; Taxation; Environment; and Food safety, veterinary and phytosanitary policy,

⁷ Free movement of goods, Right of establishment and freedom to provide services, Financial services, Agriculture and rural development, Fisheries, Transport policy, Customs union, and External relations.

For example, Portugal, Spain and Greece joined the European Community in 1986; however, whereas Portugal and Spain were able to double their average yearly FDI inflows to GDP in 1986-1990 compared to 1980-1985, Greece did not significantly increase its levels during the decade of the 1980s (Figure 2). This could be explained by the fact that, even when membership encompassed similar environmental changes (and opportunities) for the three Mediterranean countries, Greece was by that time relatively isolated in terms of location from the rest of the European markets. Similarly, it is possible to observe that CUSFTA agreement has had a lower impact for Canada than the NAFTA treaty for Mexico. The reason Blomstron and Kokko (1997) provide is that NAFTA is an extended version of CUSFTA that consider deeper integration (stronger “environmental change”); additionally, Mexico has an advantageous location in the region with respect to Canada.

Figure 2. FDI flows as a % of GDP in selected countries



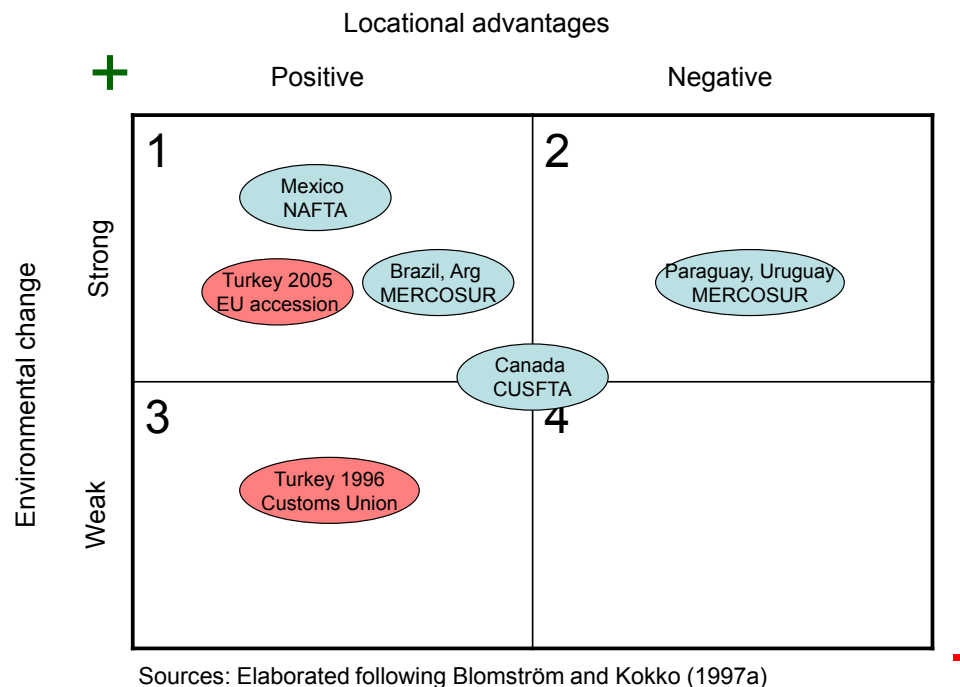
Source: UNCTAD

Drawing from this methodology, that classifies regional integration agreements according to its probable impact on foreign direct investment, we try to illustrate the Turkish case. The following diagram shows four blue ellipses, which corresponds with the position attributed by Blomstron and Kokko (1997) to their four case studies.

In the same fashion, it might be argued that the Customs Union Agreement signed by the EU and Turkey in 1996 did not help the latter to attract FDI significantly because it did not imply a strong “environmental change”. As it has been mentioned previously, the scope of the agreement was limited

mainly to trade clauses, and persisting technical barriers and obstacles to investment. Therefore, despite its theoretically advantageous location to serve Europe, Turkey had still constraints hampering the attraction of foreign investors in the second half of the 1990s.

Figure 3. Expected impact of regional integration agreements on FDI.

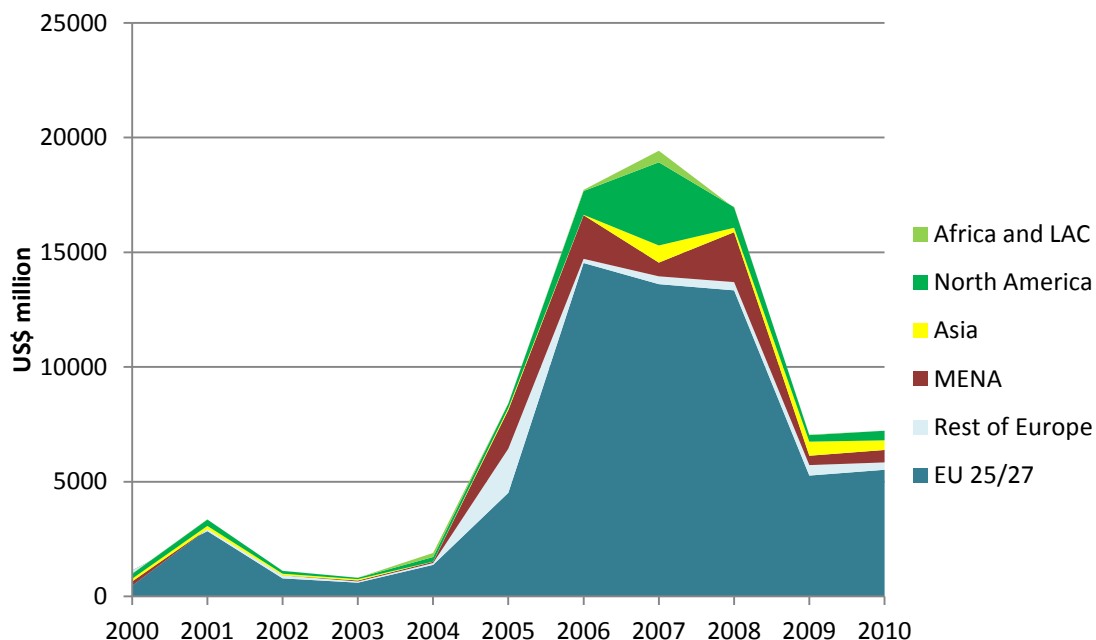


On the other hand, the beginning of the EU accession negotiations in 2005 was accompanied by a wider and deeper set of reforms in different fields such as business, economics, politics or even human rights. This wider and more credible “environmental change” has helped improving both the investment climate and business expectations in Turkey. Therefore, now it can be argued that the Turkey-EU accession partnership should be located in quadrant one, together with other regional agreements contributing positively to FDI. In addition, Turkey moved a little bit to the left hand side of the graph, reflecting increasing locational advantages, as ten Eastern European countries joined the EU in 2004.

Furthermore, we will argue that, given that Turkey is not a member of the EU yet, the relative position of the Accession Negotiations agreement may change dynamically over time, and weaker membership prospects would mean that the expected environmental and “doing business” change in Turkey could be narrower than initially expected. This could result in international investors, aiming at serving the EU market, less prone to establish their facilities in Turkey.

How has the beginning of accession negotiations between Turkey and the EU affected the geographical origin of FDI flows? Even when it would very difficult to isolate the effects of regional integration on capital flowing to Turkey, stylized facts lead to the intuition that it may have been in fact a relevant factor. As shown in the next figure, both intra and extra regional flows increased significantly since 2005, when the EU gave green light to the accession process. At the same time, it is worth mentioning the caveat that these developments took place in the context of expansion in global capital flows; in fact, FDI flows declined sharply in 2009 and 2010, in the context of global economic slowdown, and with cooling down EU accession perspectives for Turkey.

Figure 4. Evolution of FDI flows to Turkey over the past decade



Source: authors' elaboration from OECD stats, WDI

Interestingly, even when FDI flows from EU members increased in absolute terms in 2005-2008, in relative terms, Middle Eastern and Other European investors were more avid in bringing capital to Turkey (flows from these regions increased by 29 and 23 times respectively in 2005). This seems to conform to the theory, which predicts that FDI with third countries outside the region (in this case the EU) are more likely to increase than intraregional FDI when a regional integration treaty is signed. (te Velde, D. and Bezemer, D. , 2006; Blomstrom, M. and Kokko, A., 1997; Stein et al., 2003). Indeed, European Union accession negotiations are accompanied by a series of improvements in the business

framework and a series of positive externalities from which not only EU companies but also investors from other countries expect to benefit.

By sector, following the beginning of the EU accession negotiations, the largest foreign investments in Turkey have taken place in financial intermediation (47% of total FDI inflows in 2005-2008), transport, storage and communications (21%), and wholesale and retail trade (6%). This gives us the intuition that services and market oriented FDI dominates the recent inflow upsurge, which is in line with the findings in Esiyok (2011).

Figure 5. Evolution of FDI flows to Turkey by sector over the last decade

Average FDI flows by sector, % over total	2002-2004	2005-2008	2009-2013
Primary sector (including mining)	3.0%	1.2%	2.4%
Secondary sector	29.2%	17.2%	24.7%
Electricity, gas and water supply	8.6%	2.7%	24.7%
Construction	0.6%	1.5%	5.1%
Transport and communications	18.0%	21.1%	4.6%
Financial intermediation	15.6%	47.7%	26.3%
Other services	25.1%	8.5%	12.2%
Yearly average FDI flows in the period (US\$ million)	905	11863	9921

Source: authors' calculations based on Central Bank of Turkey and Ministry of the Treasury data

In 2009-2013 it is possible to observe a different sector distribution pattern, as FDI directed towards manufacturing in Turkey has recovered some of its relative weight, whereas financial intermediation and transport and communications have contracted sharply, and foreign investment in Turkish utilities and energy have surged, becoming the principal activity attracting foreign capital nowadays.

At this point, one may wonder which part of the huge amounts of foreign funds invested in Turkish financial intermediation and communications have been attracted by the privatization process. If the weight of privatization operations was large, that would mean that the rise on FDI may be a transient phenomenon after which Turkey will return to inflow levels of 0.5% to 1% of GDP. Most of the papers on privatization in Turkey are from the early 2000s (Karatas, 2001; Simga-Mugan and Yüce, 2003), which does not allow us to clarify the effects of the acceleration of reforms after 2005. Thus, we gather recent data and reports from the Turkish Privatization Administration and focus on operations involving FDI. According to the official statistics, except for 2001, FDI through privatization seems to represent just a small proportion of total inflows. For example, if we look at the top five FDI inflows in 2008, only the acquisition of *Teke/Sigara* by a British company is a privatization operation.

At the end of the 1990s, Loewendahl and Ertugal-Loewendahl (2000) argued that *<<[a] key reason for Turkey’s overall under-performance is the minimal level of privatization-related FDI>>*. However, the sale of an increasing number of state-owned companies in 2005-2010 has not been the main contributor to the upsurge in FDI inflows, as most of them have been acquired by Turkish companies.

In our view, privatization has probably contributed to recent FDI upsurge in two ways: directly by selling some State Owned Enterprises to foreign investors; and indirectly by promoting the image of a more solid and liberalized Turkish economy around the world. But, overall, it seems that privatization has only played a secondary role in boosting FDI to Turkey (Tulug, 2004).

To sum up, the Customs Union Treaty of 1996 did not help significantly to enhance foreign investment or change the origin of inward FDI flows to Turkey. On the other hand, FDI boomed once Turkey’s accession negotiations to the EU officially started (2005). One can explain the different impact of both regional integration processes on foreign investment by looking at the provisions considered in the agreements, as well as their implementation. We have argued that the EU-Turkey Accession Partnership has a much wider scope (entailing reforms in the business environment) than the Customs Union Treaty (mainly referring to trade clauses and preferences). It is also worth mentioning that the Customs Union Treaty was agreed in a period of political instability and weak governing coalitions in Turkey, whereas institutional and economic stability significantly improved over the past decade, which is likely to have also played a major role in the attraction of larger FDI inflows.

Recently, the global financial and economic crisis coupled with weaker EU accession prospects has resulted in net FDI to GDP in Turkey losing some steam (1.2% on average in 2009-2013, compared to 2.7% in 2005-2008). As observed in Figure 5 large foreign investment in electricity and energy have prevented the collapse of FDI inflows. The next section discusses some potential explanations behind this trend.

5. Case study: The energy sector in Turkey

In this section we adopt a narrower focus to try to obtain a deeper knowledge on how EU accession negotiations and the acquisition of the communitarian *acquis* may have facilitated the increase of FDI flows to Turkey, especially in 2009-2013. This is related to our hypothesis that prospects of EU accession are one of the main motivations causing the FDI upsurge observed since 2005. Energy is arguably a very attractive sector for foreign investors in Turkey for three main reasons: recent legislative

reforms, the relevance of Turkey for the energy security strategy of the European Union, and an accelerated privatization process (which does have a notable role in this specific sector).

Reforms and issued laws in the energy sector

The reforms in this field are still recent, which implies that liberalization and competition frameworks are under improvement.

On the 3rd of March 2001, an Electricity Market Law (EML, No. 4628) was issued to set the framework for a more competitive and transparent electricity market. The old state owned utility entity, TEAS, was divided into three new companies, in order to separate electricity transmission, generation and commercialization activities.

Similarly, on the 2nd of May 2001, a Natural Gas Market Law (NGML, No. 4646) came into force with the ultimate purpose of liberalizing the sector. It includes provisions to force a progressive diminution of the gas import contracts in the hands of BOTAS⁸ to 20% in 2009 (Hacisalihoglu, 2008).

On the 19th of November 2001, the Energy Market Regulatory Authority (EMRA) was created. Its purpose is to regulate the markets, issue operating licenses in the different sectors (Electricity, Gas, and Petroleum) and, ultimately, help to achieve the transition to competition⁹. Later, the Petroleum Market Law (PML, No. 5015, 20 December 2003) and the Liquefied Petroleum Gas Market Law (LPGML, No.5307, 13 March 2005) removed import quotas and liberalized market activities in the oil and LPG sectors.

These and related reforms in the energy sector have not only been motivated by the need to meet future energy demand in the country, but have also been continuously encouraged by the dialogue between Turkey and the European Union. Following the European Council of Helsinki (December, 1999), a first Accession Partnership for the new candidate state was issued (Council of Europe, 2001). The document already emphasized the need of improvements in the energy chapter with the progressive acquisition of the EU *acquis communautaire*, the establishment of an independent regulatory authority and the implementation of the electricity and gas Directives. Since then, the EU has been issuing regular progress reports, as well as updating the Accession Partnership, always monitoring the developments of the energy sector.

⁸ BOTAS is the Turkish to Pipeline Corporation. During the 1990s the company officially enjoyed the right to monopolize natural gas distribution. The Natural Gas Market Law of 2001 abolished this right.

⁹ EPDK, 2007. “Manual For Energy Investors”. Republic of Turkey, Energy Market Regulatory Authority. May, 2007.

When the implementation of reforms is slow or insufficient, the EU will reflect it in its documents and ask for a strengthen dedication to match requirements. For example, the EU Commission (2008) denounced in 2007 that BOTAS still imported 86% of the natural gas consumed in Turkey, when, according to the law, by 2009 the share of the company should be of only 20%. This example illustrates the fact that in some areas competition remains limited. Yet, it also proves the EU commitment to monitor the liberalization of the energy sector in Turkey. Thus, we argue that the pace of this process will clearly remain linked to the progress made in European integration.

The Geo-strategic relevance of Turkey as an energy hub

The role of Turkey as an energy bridge between East and West has been widely studied from a geo-strategic and energy security perspective (Ozturk et al, 2011; Akdemir, 2011; Tagliapietra, 2013). In addition, even if Turkey was below world average with a consumption of 58 million BTU¹⁰ per capita in 2007, natural gas demand is expected to grow at a yearly average rate of 4.9% between 2010 and 2020, with manufacturing facilities and power plants as the main customers (Hacisalihoglu, 2008). The dependency from foreign energy sources caused a severe crisis in Turkey during the 1970s, as oil prices surged, and with it balance of payments deficit and inflation. Since then, and given the lack of significant oil and gas reserves, Turkey has tried to take advantage of the geographical position in order to be part of different energy corridors that can help to diversify supplies. The attraction of foreign direct investment depends also on market conditions, as discussed by Bilgili et al (2012), who find that in fast FDI growth periods (such as 2005-2010), FDI inflows to Turkey are negatively correlated to the price of electricity and the prices of oil and gas in the domestic market.

In addition, strategic decisions in the energy field are intimately interlinked to foreign policy and the relationships with energy-rich neighboring countries (Russia, Iran, Iraq, Azerbaijan, Kazakhstan, Turkmenistan, etc.). Approximately three quarters of world's proven natural gas and oil resources are located in Russia, the Middle East and Caspian Regions. According to Ozturk et al (2011), Turkey's national energy policy involves reducing dependency and diversifying geographically the sources, ensuring sustainable, high quality and cheap supplies, and functioning as a transmission hub.

The key role of Turkey in natural gas and oil distribution is formally recognized in the Trans European Energy Networks project (TEN-E) and the Energy Security Strategy of the European Union (see European Commission, 2006). Even if oil and natural gas deposits in Anatolia are scanty and national

¹⁰ Source: www.eia.com. British Thermal Unit, equivalent to 1.055 kilojoules.

production is low (EIA, 2009), Turkey is very relevant as a transit country, and it is considered a potential alternative route to diminish EU dependency on Russian natural gas¹¹.

In regards to oil, Turkey counts with two pipelines to import crude from Azerbaijan and Iraq. Both routes end at Ceyhan, one of the main crude export seaports in the Mediterranean sea, together with Izmir and Istanbul. All of them count with refineries in their proximities; Turkey exports part of their production of refined oil and derivatives to different countries such as Italy, Singapore or even the United Arab Emirates. Still, it is important to bear in mind Turkish dependence on Russia and Iran, its main oil suppliers, which complicates Turkey's political alliances and regional strategy. On the other hand, Turkey has some leverage on the transit of ships through the Bosphorus, and has recently limited the size and the number of tankers going through the straits. This is one of the reasons why Russia is considering several projects to by-pass the Bosphorus.

In regards to natural gas, Turkey is being supplied through ground routes coming from Russia (Blue Stream and West Pipeline), Iran (Shah Deniz pipeline) and Azerbaijan (Shah Sea pipeline). Turkey is also purchasing Liquefied Natural Gas (LNG) to Nigeria and Algeria, and has recently started to export gas to Greece through an inter-connector that crosses the South straits of the Marmara Sea, and could eventually be used to transport natural gas to Italy (see Özturk et al, 2011).

Looking ahead, Turkey is willing to take advantage of its strategic geographical position to become an energy hub in between the Middle East, Central Asia and Europe (Saivetz, 2009; MFA, 2009). At the same time, the European Union has manifested an interest to build trans-national energy networks and, more concretely, alternative routes to diminish its dependency on Russian gas (European Commission, 2006).

In this context, on July 2009 four EU members and Turkey reached an intergovernmental agreement to allow the construction of a large pipeline (31 Bcma¹²) called *Nabucco*, which would transport Azeri gas to Austria¹³. This flagship European project was for some time one of the best bets by Turkey to eventually become a full EU member. However, Nabucco faced the problem that Azerbaijan itself cannot supply enough gas to fill the pipe. Moreover, there was international controversy with Iran, and the project of a Trans-Caspian link to access Turkmenistan is blocked by legal disputes over Caspian waters (Cornell and Nilsson, 2008:141-154). According to Erdoğan (2010), the problems in securing guaranteed supplies of gas for the project would ultimately result in lack of sufficient financing.

¹¹On European Energy security see the INOGATE Network, European Energy Strategy.

¹² Billion cubic meters per annum.

¹³ Euroactive (2009) [EU countries sign geopolitical Nabucco agreement](#), 14th July.

In addition, Russia announced a *South Stream* pipeline, which plans to go from the Russian Caucasus directly to Bulgaria and Central Europe, to challenge the *Nabucco* project (see Baran, 2008). Turkey conceded to participate also in this *South Stream*, allowing the pipeline to go through its territorial waters, as per an agreement with Moscow signed in December 2011. At the same time, in December 2011, Turkey signed a Memorandum of Understanding with Azerbaijan aimed at building a larger Trans Anatolian Pipeline to transport gas from the Shah Deniz field through Georgia. This may result in Nabucco being sidelined in favor of this BP-SOCAR project to develop a Trans Adriatic Pipeline (TAP), with capacity to transport 10-20 Bcma. TAP is planned to be connected to the Trans Anatolian Pipeline and the existing Turkey-Greece interconnector. The Shaz Deniz consortium opted in June 2013 to supply Europe through a Trans Adriatic Pipeline given the limited progress project Nabucco has achieved so far (Roncero and San Martín, 2013).

In sum, there is an authentic geo-strategic chess battle taking place around Turkey in the energy field. In this context, delayed EU accession and recent tensions with Israel may well cause that Erdogan's AK party turns the back on the traditional allies of Turkey just to get closer to other main regional actors like Iran or Russia (see Bhadrakumar, 2008). In fact, in light of delays in the development of the Nabucco project, Turkey is already agreeing on alternative gas routes with Russia and Azerbaijan. According to Escribano (2013), the last EU energy infrastructure vision is characterized by being relatively short-sighted, and does no longer consider a flagship long-term project such as Nabucco, which could greatly help to diversify natural gas supply routes into Europe.

We will argue that, depending on policy choices and regional integration decisions in the following years, gas and oil will be more likely to flow one way or the other, affecting both trade flows and multinational establishments in the energy sector. For instance, as we discuss in the next section, companies such as Austrian OMV, which had already been investing in Turkey to set the stage for Nabucco, may have suffered a severe downturn in their expectations. Even if, in the end, Azeri gas is still likely to flow to Southern Europe through Anatolia, (Central) European energy firms may have seen their investment prospects damaged by the alternative, smaller-scale TAP pipeline, which in the end could imply a lower potential of energy-related FDI flows to Turkey in the following years.

Foreign Direct Investment and Privatization

Which are the links between this geopolitical game and FDI in the energy sector in Turkey? Even when it is difficult to identify clear and obvious relationships, a look at the main merge and acquisition operations in the sector shows that Austrian OMV and German RWE, both participants on the

construction of Nabucco, were among the most active actors in utility deals in 2008-2010. At the same time Gazprom was taking positions with the acquisition of Bosphorus Gas. On the other hand, SOCAR (Azerbaijan) has increased its presence in Turkey following the signature in December 2011 of the Memorandum of Understanding for the construction and operation of the abovementioned Trans-Anatolian Pipeline.

Figure 6. Recent mergers, acquisitions and other operations by foreign investors in the utilities, gas and oil sector in Turkey

Date announced	Company	Stakes %	Acquirer	Origin of investor	Sector
15-Mar-08	Baskentgaz	90%	Global - Energaz - ABN Amro	Turkey - Netherlands	Utilities
23-Apr-08	Kayserigaz	40%	EWE AG	Germany	Utilities
1-Jul-08	Baskent Elektrik Dagitim	100%	Sabancı - Verbund - EnerjiSA	Turkey - Austria	Utilities
1-Jul-08	Sakarya Elektrik Dagitim	100%	AkCEZ	Turkey - Czech R.	Utilities
11-Jul-08	Bares Elektrik Uretim	100%	Italgen SpA	Italy	Utilities
28-Jul-08	Akpet	100%	Lurkoil	Russia	Oil and gas
30-Jul-08	Tasyapi Enerji Grubu	50%	Cogentrix Energy	USA	Utilities
15-Aug-08	Izgaz	90%	GdF Suez	France	Utilities
28-Sep-08	Borascos	60%	OMV	Austria	Utilities
8-Oct-08	Ak Enerji Üretim	37%	CEZ	Czech Republic	Utilities
23-Oct-08	Kayserigaz	40%	EWE AG	Germany	Utilities
23-Oct-08	Bursagaz	40%	EWE AG	Germany	Utilities
9-Dec-08	Polat Enerji	50%	EdF Novelles	France	Utilities
4-Mar-09	Borusan Enerji	50%	EnBW	Germany	Utilities
9-Mar-09	Palmet Enerji	13%	Manitoba Hydro Int.	Canada	Utilities
19-Mar-09	Yesil Enerji	95%	Statkraft	Norway	Utilities
23-Mar-09	E.ON Turcas Kuzey Elektrik	70%	RWE	Germany	Utilities
23-Mar-09	E.ON Turcas Güney Elektrik	70%	RWE	Germany	Utilities
13-Apr-09	Enerco Enerji	40%	OMV	Austria	Utilities
11-Jun-09	EWE Dogalgaz	100%	EWE	Germany	Utilities
17-Jun-09	Borascos Elektrik	15%	OMV	Austria	Utilities
20-Aug-09	Bosphorus Gaz	31%	Gazprom	Russia	Utilities
1-Oct-09	Toreador Turkey	100%	Tiway Oil	Norway	Oil and gas
12-Oct-09	Power Station	100%	RES	UK	Utilities
24-Mar-10	Six local hydro projects	75%	Reservoir Capital	Canada	Utilities
30-Apr-10	Five local hydro projects	100%	Energo-Pro	Czech Republic	Utilities
5-May-10	Amity Oil and Zorlu Petrogas	100%	TransAtlantic	USA	Oil and gas
3-Jun-10	Anel Enerji	5%	Ralos New Energies	Germany	Utilities

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“How regional integration and transnational energy networks have boosted FDI in Turkey”

2-Aug-10	Aves - S-OIL JV	75%	NuStar	USA	Oil and gas
23-Oct-10	Petrol Ofisi	54%	OMV	Austria	Oil and gas
1-Dec-10	Entek Elektrik	50%	AES	USA	Utilities
10-Feb-11	Thrace Basin Natural Gas	100%	TransAtlantic (35%), Valeura Energy (40%), Pinnacle (25%)	USA, Bahamas, Canada	Oil and gas
21-Apr-11	Arar Petrol and Gas	5%	Niche	UK	Oil and gas
24-Jul-11	Yeni Elektrik Uretim	40%	Ansaldo Energia	Italy	Utilities
28-Oct-11	Aksa Enerji	15%	Goldman Sachs	USA	Utilities
23-Dec-11	Enda Enerji	100%	Hot Rock	Germany	Utilities
28-Dec-11	SOCAR & Turcas Enerji	25%	SOCAR	Azerbaijan	Oil and gas
12-Mar-12	Avrasya Gaz	60%	Prima Energy Trading	Russia	Oil and gas
9-May-12	Petkim	10%	SOCAR	Azerbaijan	Oil and gas
29-Jun-12	AkCez	23%	CEZ	Czech Republic	Utilities
17-Jul-12	Trakya Elektrik Üretim	90%	Inter RAO	Russia	Utilities
10-Sep-12	Karasular Enerji	40%	Aquila Hydropower INVEST	Germany	Utilities
27-Nov-12	Petgaz & wholesale LPG	100%	Rus Oteko	Russia	Oil and gas
4-Dec-12	EnerjiSA	50%	E.ON AG	Germany	Utilities
12-Dec-12	Petrol Ofisi Petrol Arama	100%	Tiway Oil	Norway	Oil and gas
12-Feb-13	Aksa Enerji	3%	Goldman Sachs	USA	Utilities
14-Mar-13	Karasular Enerji Uretimi	60%	Aquila Capital Wasserkraft	Germany	Utilities
12-Jun-13	Benal Danismanlik	100%	Aswar National	Kuwait	Utilities
16-Aug-13	Bagistas II Hydro Plant	100%	Globtec	Germany	Utilities
25-Sep-13	Alpay Enerji	75%	San Leon Energy	U.K.	Utilities
18-Dec-13	Global enerji Elektrik Uretim	15%	Emkaan In+D2:D53vestment	U.A.E.	Utilities

Sources: Pricewaterhousecoopers. Turkey Energy Deals (2008-2014).

Pricewaterhousecoopers (2009) referred to some of these interesting deals in this fashion:

<<[...] the deal wheels in the natural gas sector were lubricated by interest from foreign utility companies in the midstream zone. Gazprom increased its shares in BosphorusGaz, a Turkish company holding a license to import 750mcm of gas per year from Gazprom itself. Another private natural gas importer, Enerco, licensed to import 2.5bcm of gas per year also from Gazprom, got to be a deal subject and sold its 40% share to OMV. In this way, the Austrian company added gas import to its existing operations in fuel retail and power generation markets in Turkey [...]>>

Strategic movements in electricity, natural gas and oil distribution have been facilitated by liberalization in these sectors. Privatization effectively started around the year 2000, and has been accelerated in the past five years in what regards electricity supply and gas distribution; however, upstream industries are not fully opened to international competition yet.

The ongoing liberalization and full privatization of the monopoly held by BOTAS, the Turkish Pipeline Corporation (Erdogdu, 2007:14; EPDK, 2007:15), is probably one of the events most anticipated by foreign investors. Turkish legislation obligates BOTAS to sell distribution branches, as well as to separate commercialization and transportation activities. These measures are considered by the experts as very favorable to the creation of competition within the Turkish energy sector (Mazzanti and Biancardi, 2005).

However, it seems that the cooling down of EU accession prospects and recent economic and political instability have resulted in a recent decline on foreign involvement in energy merges and acquisitions in Turkey, from 42% participation in total deals in 2011 to 25% in 2012 and 1% in 2013 (Pricewaterhousecoopers, 2008-2014). Local companies are nowadays dominating energy deals and privatization-related acquisitions. In addition, European companies such as RWE and OMV have not been active in the acquisition market for a while, as the prospects for the completion of Nabucco have been severely reduced.

Overall, this brief geo-political and geo-economic analysis shows how laws (legislative level), international relations (state level) and FDI decisions (firm/private level) are intimately related. Furthermore, the energy sector in Turkey has been experiencing privatization and liberalization processes at its different sectors (electricity, natural gas, oil, renewable sources...) and levels (generation, distribution, commercialization, etc.). These reforms are partly motivated by Turkey's accession negotiations with the European Union, who is at the same time interested in counting a safe

energy corridor through Anatolia. Therefore, we argue that the evolution of relations with the EU will affect decisions taken by foreign investors in the energy sector in Turkey. Worsening EU membership prospects may delay domestic reforms and difficult the way to European multinationals trying to participate in the Turkish energy market in the future.

6. Conclusion and way forward

The Turkish economy has been characterized as suffering from difficulties to attract foreign direct investment. Net FDI inflows averaged 2.7 % of the Turkish GDP in 2005-2008, and 1.2% of GDP in 2009-2013, compared to less than 0.5% of GDP in 1990-2004. According to the literature, macroeconomic and political instability were probably discouraging foreign investors, as sudden stops were frequent in the 1990s in a context of capital account liberalization.

How can the boost in FDI inflows observed in 2005 be explained? A recent and increasingly predominant strand of studies argue that, apart from improved economic and political stability achieved over the last decade, the beginning of accession negotiations with the EU in 2005 has significantly contributed to boost FDI. Most of the existing literature tries to "capture" this "EU accession" effect using a dummy variable in cross country regression or gravity models. This paper, in turn, complements existing empirical evidence by opening this "black box" and trying to understand which factors and which concrete policy actions explain the recent increase in FDI.

In this sense, we use the qualitative discussion framework elaborated by Blomstrom and Kokko (1997) to assess the potential implications of free trade agreements on FDI. We argue that the Customs Union Treaty for industrial products, signed between Turkey and the EU in 1996, was successful in achieving its aim of helping increase bilateral trade flows, but did not entail a significant increase in FDI inflows because it did not imply strong environmental and policy changes for investors, and there was a five-year margin for implementation. In turn, the official start of EU accession negotiations in 2005 encompassed a wide set of reforms in a number of chapters of the *acquis communautaire* that were directly or indirectly affecting the business climate.

In addition, we argue that both developments in accession talks and foreign policy decisions assumed by Turkey will dynamically shape the impact of EU integration on FDI attraction: the same way the beginning of accession negotiations with the EU functioned as a market signal that helped to achieve yearly FDI to GDP inflows six time higher in 2005-2008 than in previous years (Sayek, 2007), the global economic slowdown starting in 2009 and increasing *Euro-skepticism* may mitigate this "EU effect" in the following years. According to a survey by the International Investors Association (YASED, 2013), local

political turmoil, problems in international financial markets, Turkey’s persistent current account deficit, lack of sustained growth and the slowdown in EU accession negotiations are perceived as the potential adverse developments that could affect most of Turkey’s prospects for FDI inflows. This would mean that political and macroeconomic stability are re-emerging as the main concerns for foreign entrepreneurs, in a moment in which EU accession prospects for Turkey have already weakened significantly, with the country losing the initial boost provoked by the “signaling effect” mentioned before.

In fact, in 2009-2013 we have already seen a contraction of FDI inflows, and only growing foreign investment in the energy sector has prevented a collapse. The marked increase in foreign presence in the Turkish electricity, gas and oil sectors can be explained by reforms aimed at liberalization, an accelerated privatization process, and the relevance of Turkey for the energy security strategy of the European Union. It is also worth mentioning the agreement between Azerbaijan and Turkey (June 2013) to transport gas from the Shah Deniz field to Europe through a Trans Adriatic Pipeline. This may be partly a result of delays in the agreements leading to the construction of the Nabucco pipeline, a project that has been at the center of the EU energy corridors strategy, and is likely to result in diminishing presence of European investment in eventual FDI inflows to the energy sector in Turkey.

In sum, qualitative analysis of the Turkish case shows how, beyond macroeconomic and political stability, state-level decisions such as regional integration processes and the choice of allies from a foreign policy / geopolitical perspective are likely to have an impact on actions taken by foreign investors. This has a series of policy implications.

First, a delayed EU accession or the possibility of being marginalized in an eventual EU-US Transatlantic Trade and Invest Partnership (Chislett, 2013) are likely to deter European FDI to Turkey in the future. Thus, Turkish policy makers could continue working on the enhancement of the relationship with other neighboring countries, and the pursuit of other regional integration initiatives should not be ruled out. Here, the Organization of the Black Sea Economic Cooperation (Cornell and Jonsson, 2006), different Middle East and Central Asia countries, Russia and Iran may be considered as potential partners. Working in alternative regional initiatives, Turkey would be able to reduce the dependency on EU investments, continue enhancing its role as a regional actor, and improve its bargain power with traditional allies (Onder, 2007).

Second, from the point of view of the foreign investor, it can be argued that Turkey will remain relatively attractive as a country to establish subsidiaries. Turkey counts both with a large and quickly

growing internal market (for horizontal FDI) and the possibility of serving as an export platform to serve manufacturing products to the EU (vertical FDI), thanks to the Customs Union agreement. Even if progress in some areas of the *acquis communautaire* is slow (free movement of goods, right of establishment and freedom to provide services...), the continuation of EU accession talks is a guarantee of progressive improvement in the business framework.

Moreover, the ongoing privatization of utilities and energy transmission in Turkey should appeal the foreign investor. Even if the Nabucco pipeline is not finally built, Turkey continues to be at the center of important international oil and gas corridors, and has a stake in new projects aimed at transporting gas to Europe: the Trans Adriatic Pipeline and the South Stream.

Finally, an implication for both policy makers and researchers around the world is that, apart from macroeconomic, political and institutional stability, regional integration matters for foreign direct investment attraction. But not any kind of regional integration initiative may be sufficient to appeal to the foreign investor. In line with Blomstrom and Kokko (1997), we argue that the deeper the environmental change the agreement encompasses, the more powerful it will be in enhancing FDI inflows. Free trade agreements or customs unions with a focus on trade preferences are often unable to help significantly enhancing FDI attraction due to the persistence of red tape and hurdles in the business environment. In turn, most Accession Partnership Agreements signed by the EU and candidate countries seem to have boosted FDI, as they encompass the progressive adoption of the *acquis communautaire*, which is interpreted by foreign entrepreneurs as a guarantee of reforms leading to productivity increases, economic opportunities, and enhancement in the investment framework.

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8. Annex. Summary of the literature review

Table 1. Studies on foreign direct investment in Turkey

Authors	Year	Topic	Methodology	Theoretical Approach/ Determinants	Focus	Conclusions - relevant results for our study
Tatoglu and Glaister	1998	Drivers of FDI in Turkey - Locational Specific Factors	Micro - Survey (factor analysis)	Location, Ownership and internalization (OLI)	Determinants	Low cost inputs and geographical proximity are more important for European investors than for the USA/UK multinationals. Following Turkey's accession to the customs union with the EU in January 1996 the number of FEV formations with firms from EU countries is expected to increase.
Tatoglu and Glaister	2000	Dimensions of Western Foreign Direct Investment in Turkey	Micro - Survey	Location, Ownership and internalization (OLI)	Determinants	They specify some of the location, transaction and firm related factors that are influential in the establishment of foreign companies in Turkey. Still, they recognize the need to complement with a macroeconomic approach
Tatoglu et al	2003	Determinants of Foreign Ownership in Turkish Manufacturing	Micro - Survey (Logit regression)	(OLI)	Determinants	Country-related factors influence foreign ownership choice (WOE vs JV). Turkey should continue liberalisation
Deichmann et al	2003	Location - distributional patterns of FDI within Turkey	Quantitative (Logit regression)	Location specific factors + Policy	Determinants	Location decision depends on the industry (productivity, agglomeration) and on regional conditions (coastal access, infrastructures, etc.). Public investment's share on regional GDP does not seem to be an influencing factor.
Lenger and Taymaz	2007	FDI and spillovers in Turkish Manufacturing	Micro - Survey	(OLI)	Consequences of FDI	Foreign owned firms are on average more innovative than domestic ones. They also find that the main channel of spillovers is employee acquired knowledge.
Erdilek	2003	Comparative study of inward and outward FDI flows in Turkey	Political economy analysis + Survey	Macroeconomic determinants + Policy	Performance	The author blames internal factors such as economic instability and lack of willingness among politicians to attract FDI as the cause of Turkey's dismal performance in attracting FDI.
Tulug	2004	Drivers of FDI in Turkey	Micro - Survey	Macroeconomic determinants + Policy	Performance	The results indicate that economic and political instability is the main deterrent to FDI.
Uctum and Uctum	2005	Portfolio Flows, Foreign Direct Investment, Crises	Quantitative (model)	Macroeconomic	Other (structural breaks)	FPI is vulnerable to regional contagion (Russian crisis) and responds negatively to financial risk, while FDI is sensitive to economic risk but is not affected by contagion. They detect structural breaks in Turkey in 1998 and 2000.
Basar and Tosunoglu	2006	Turkish problems to attract FDI	Quantitative (multivariable)	Macroeconomic	Performance	Turkey seems to be attracting less FDI than expected, probably a result of high inflation rates and macro instability
Dumludag et al	2007	Determinants of Foreign Direct Investment from an institutional perspective	Quantitative (cross country) and questionnaire	Macroeconomic determinants + Policy (institutional)	Determinants	Institutional improvement is needed in order to increase inward FDI. In Turkey political and macroeconomic instability (related to a lack of strong institutions) are seen as the most significant facts that hinder higher inflow of FDI.

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Onaran	2009	Changes in the wage share in the manufacturing in Mexico, Turkey and the Republic of Korea	Quantitative (3 countries)	Other	Consequences of FDI	FDI inflows have not brought the expected improvement on worker's real wages
Cetin and Taban	2009	impact of FDI on trade with the EU	Qualitative (multivariable)	Other	Consequences of FDI	FDI contributes positively to foreign trade. Japanese and EU FDI are export-oriented and thus contribute to the rapid growth of Turkish exports, while US FDI is anti-export-oriented and thus leads to decreases in Turkish exports
Bilgili et al	2012	Non linear determinants of FDI in Turkey	Quantitative (single country, Markov)	Macroeconomic and institutional	Determinants	FDI is positively correlated with economic growth in Turkey, decreasing country risk and expansion in exports, whereas labor costs, imports and currency depreciation expectations have a negative impact on FDI in Turkey. The relationship of energy costs with FDI shows a significant non-linearity.
Loewendahl, H. B. and E. Ertugal-Loewendahl	2000	EU's enlargement and Turkey's position in attracting FDI	Political economy analysis + Micro Survey	Mixed macroeconomic + Location + Policy	Performance/Regional	Late accession to the EU will cause that Turkey continues to fall behind Central and Eastern Europe countries. Policy recommendations: privatize, keep improving human capital, infrastructures, teleco and develop an active FDI attraction agency
Dutz et al	2005	Turkey's Foreign Direct Investment Challenges: Competition, Rule of Law and the EU Accession	Political economy analysis (+3 case studies)	Macro economic determinants + Policy	Performance/Regional	Lags behind in its energy infrastructure, its level of computerization, and the availability of credit for the private sector. EU accession process should provide Turkey with significant FDI inflows helping to ease rule of law and competition constraints
Zaman	2005	Impact of accession negotiations on FDI and trade	Political economy analysis	Not clear	Consequences of FDI	Predicts boost in FDI inflows in the aftermath of accession negotiations. Caveat: subjective analysis
Sayek	2007	Determinants of FDI in Turkey, and the impact of EU accession	Quantitative (cross country)	Location specific factors + Macroeconomic	Determinants	The author attributes the recent increase in FDI inflows mainly to integration prospects. The reduction in inflation does not seem to have played a major role in this late success.
Gungor and Binatli	2010	Determinants of FDI in Easter Europe and Turkey, and the impact of EU accession	Quantitative (cross country)	Macroeconomic	Determinants	Analyze a panel data consisting of eleven countries involved in EU accession, including Turkey, and conclude that progress in this process result in a significant increase of FDI inflows.
Uckun and Doerr	2010	Turkish reforms post 2001	Political economy analysis	Macroeconomic + policy	Other (reforms)	Both reforms in the investment framework and availability of global financial funds during 2003-2008 facilitated FDI upsurge in Turkey
Esiyok	2011	Determinants of FDI in Turkey, a capital-knowledge approach	Quantitative (cross country)	Macroeconomic + Policy	Determinants	Esiyok (2011) finds that FDI in Turkey is mainly horizontal. FDI flows to Turkey respond positively to the EU accession process, as well as to bilateral trade treaties with third countries.
Bosco	2012	FDI in Turkey, unexploited potential	Quantitative (cross country, gravity model)	GDP, distance, EU	Determinants	GDP per capita and distance, but not human capital availability, are significant determinants of FDI. Turkey has an unexploited potential in terms of FDI stock of 200% to 1000%.

Source: authors' elaboration